The Empire Board's Responsibilities

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Several responsibilities devolve on the not-for-profit board of Empire Blue Cross and Blue Shield[a] as it considers the proposed restructuring. The Empire case demonstrates the particularly thorny issues boards face when changed circumstances call into question the viability of a not-for-profit's traditional operations. In such a context, it can be particularly difficult to reconcile what has been called the board's "duty of obedience" to the organization's charitable mission with its duty to protect the value of the entity's assets. Empire's board believes that simply continuing operations along current lines would ultimately result in its gradual, or perhaps not so gradual, decline in what is now a hotly competitive environment. (This environment was not of Empire's devising, but it is the environment in which Empire must survive.) Such a result obviously does not protect the value of Empire's assets, and, equally obviously, it inhibits or ultimately eliminates Empire's ability to perform its charitable mission of ensuring wide availabil-

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[a] Empire Blue Cross and Blue Shield is currently organized as not-for-profit pursuant to Section 102(a)(5) of New York's Not-For-Profit Corporation Law ("NFPCL"). Empire is a Type B corporation under NFPCL §201, is licensed as a nonprofit health service corporation pursuant to Article 43 of New York's Insurance Law, and holds a Certificate of Authority to operate a health maintenance organization ("HMO") under Article 44 of New York's Public Health Law.

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ity of health care to New Yorkers. Empire's board sought a better way, one that protects Empire's assets and perpetuates both its business operations *and* its charitable mission.

I believe that Empire's board has diligently, and with great ethical concern, considered all the alternatives to assure Empire's survival and continued achievement of its historic charitable goals, and that it has chosen a prudent course.

Given the alternatives, the Empire board's plan to transfer the business to a for-profit entity capable of obtaining the capital required to compete in the current health-care insurance and managed-care market, and at the same time to create a charitable foundation to carry on Empire's charitable purposes, is a measured and prudent response. Importantly, it is designed to ensure that the value of the assets long devoted to Empire's historic mission will remain so dedicated and have a chance to grow, rather than to erode continuously in a futile effort to compete with for-profit organizations whose access to capital will ultimately overwhelm Empire. Indeed, the board's plan is probably the best way to dedicate adequately those assets consistent with the board's fiduciary duties.

I am personally interested in how boards function and how they are held accountable in all sectors. Issues of board function and accountability are of critical importance. Boards, whether for-profit or not-for-profit, are ultimately responsible for the actions taken or not taken by the myriad non-governmental institutions through which our economy and our society are ordered.

Role of the Board

The board sets the tone of an institution by developing an identity of purpose and ensuring continuity. It also defines the objectives that will further the institution's mission, approves strategies to achieve those objectives, provides checks and balances by monitoring managerial activity and protecting against potential managerial self-dealing, provides accountability to the institution's constituents whether public, private, or both, and ensures that the institution's mission is carried out successfully in an ever-changing environment.

All boards, whether for-profit or not-for-profit, share the responsibility to build an effective organization.[b] In doing so, directors of for-profit and not-for-profit organizations are subject to similar duties of care and loyalty. The duty of care requires that directors use that degree of care that a prudent person would ordinarily exercise in a like position and under similar circumstances.[c] This requires directors to exercise their judgment with due regard to the nature, operations, finances, and objectives of the organization. (Generally, directors who act on informed judgment are protected from liability if, in hindsight, their judgment turns out to be incorrect.[d]) The duty of loyalty requires that directors pursue the interests of the organization rather than their own financial or other interests. It seeks to protect against self-dealing and conflicts of interest.

One can generally summarize for directors these responsibilities with the simple advice to "do the right thing."

The chief distinctions between for-profit and not-for-profit organizations are the pole star that guides their conduct and the identities of their primary constituencies. For-profits and not-for-profits obviously differ in to whom and for what purpose they are held accountable. This difference is fundamental and accounts for the very distinct focus of each type of organization's management and board. As Peter Drucker has observed: "The [profit-seeking]

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[b] Nonprofit and for-profit boards have similar functions. They select, monitor, evaluate and, when necessary, replace the CEO; review and approve a long-term strategic direction and other specific objectives; ensure that necessary resources are in place to pursue strategy and achieve objectives; ensure that the organization operates effectively and responsibly; nominate suitable candidates for board election, and establish an effective system of board governance.

[c] Under NFPCL §717(a), directors of nonprofit corporations have the obligation to discharge their duties in good faith, and with that degree of diligence, care, and skill that an ordinarily prudent person in a like position would exercise under similar circumstances.

[d] The "business judgment rule" constrains courts from interfering inappropriately with decisions made by the board. NFPCL §717(b) ("Persons who so perform their duties shall have no liability by reason of being or having been directors... "). The duty of care requires that directors be reasonably acquainted with the entity's affairs. They should attend board meetings and meetings of board committees on which they serve; request (and receive) the information necessary to perform their responsibilities; review and understand material submitted to the board prior to meetings on matters put to vote; make reasonable inquiry where a problem exists or a manager's report does not make sense; and exercise independent and informed judgment.

businesses I work with start their planning with financial returns. The nonprofits start with the performance of their mission."[1]

For the publicly traded corporation, the pole star that guides board and management decisions is long-term shareholder value through the efficient production of goods and services. Shareholders are the primary constituents to whom for-profit boards and managements are accountable. While there is much debate about the time-frame in which shareholder value should be considered and to what extent other constituent groups, such as employees and communities, are relevant to the for-profit mission, the mission, itself, is straightforward—it is perpetuation to achieve "shareholder value" or "profit."

In the not-for-profit sector, the pole star that guides the board and management depends on the specific charitable purpose for which the nonprofit entity is organized. For example, the pole star of the Whitney Museum board is"to preserve, collect and exhibit 20th-century American art." The Central Park Conservancy board's pole star is "to promote and assist the restoration, preservation, and improved maintenance and safety of Central Park;. . . to develop increased public interest in [the] Park; [and] to solicit, hold, and invest funds" to do so. The board of Empire, which was originally formed to help workers pay the costs of hospitalization and provide financial support for hospitals,[e] must aim "to provide hospital, medical and other health care benefits" for subscribers; it must ensure that health care is widely available to New Yorkers.

The specific purpose of a not-for-profit organization guides the legal duties of the board because it receives special status based on that purpose. Not-for-profit corporate status is granted by state law to further the provision of the general purpose of providing a specific, stated public benefit. Tax and other benefits (i.e., regu-

[e] Empire traces its origins to the organization of Associated Hospital Services (AHS), which was designed in 1934 to help the average person pay the costs of hospitalization and to provide a broader base of financial support for hospitals. It originally covered 17 downstate counties. United Medical Service (UMS), a prepaid physician plan, was created in 1944 by the merger of Community Medical Care and the Medical Expense Fund of Greater New York. In 1974, AHS and UMS merged to create Blue Cross and Blue Shield of Greater New York. In 1985, Blue Cross of Northeastern New York merged with BC/BS of Greater New York to form Empire Blue Cross and Blue Shield.

latory exemptions) are typically granted to the not-for-profit organization by local, state, and federal governments, in effect subsidizing the purpose. Therefore, an eleemosynary organization that benefits from this special state-sanctioned status and subsidy is held legally accountable to use its resources, manage its property, and exercise its efforts for its stated purpose.

As fiduciaries, not-for-profit board members have obligations to uphold the organization's purpose as defined in the charter, the governing instrument that expresses the purpose for which the organization was formed and thus determines what the organization can or cannot do. The board's legal responsibility in this regard is sometimes referred to as its "duty of obedience."[2] It has been explained as follows:

> In short, [boards] exist for the sustenance of a mission, for the perpetuation of an institution in which [the mission] is embodied over time in such a way that the future is not mortgaged to the present and, by fiduciary obligation, for the direct care and preservation of corporate assets entrusted specifically for the pursuit of a particular mission and its related goals.[3]

Thus, although not-for-profit directors are not guarantors of the success of the organization's investments, activities, programs, or grants, they are responsible for operating the entity and managing its assets *to achieve its stated purpose.*

When the operating environment changes, such that continuing *status quo* operation is uneconomical, not-for-profit boards face a considerable challenge to protect assets and perpetuate the organization, while meeting the "duty of obedience." This is demonstrated graphically in the case of Empire.

Empire's Dilemma

Grounded in its charter, the focus of Empire's charitable purpose is enabling New Yorkers to obtain adequate health care by providing health-related benefits to workers. Ideally, any not-for-profit health-care company would charge premiums equal to the sum of the claims paid plus the cost of administering health insurance. In effect, the premiums from healthy subscribers pay for the needs of those having significant health problems. As Empire grew, some insurance products proved more successful than others; some were profitable and others represented losses. The profitable products were used to support the losing products, thus enabling Empire to serve as an insurer of last resort. (Until recently, Empire was the only carrier required to offer its health insurance policies in an open enrollment, community-rated basis.)

The fact that Empire found certain insurance products to be profitable meant that profit-seeking corporations could offer them as well. Indeed, some commentators have questioned whether it is even appropriate for not-for-profits to be engaged in—and receive tax exemptions for—activities that can and do attract for-profit entities. Empire's rationale for continuing to engage in these "profitable" lines was that it furthered the charitable purpose of providing access to health care for New Yorkers who could not otherwise afford such care. Over time, two separate but related purposes developed: a business purpose and a separate charitable purpose, both in keeping with Empire's chartered mission. Excelling at the business purpose enabled the broader fulfillment of the charitable purpose.

In the past decade a confluence of political, social, economic, and regulatory forces has changed the very nature of health care and the health and medical coverage business. The changes are fundamental and call into question the ability of a not-for-profit to deliver services in this industry. It is an understatement to say that Empire faces a significant challenge in the current operating environment:

- Empire is no longer the primary company offering health-care coverage to New Yorkers. It competes with well-managed, well-capitalized companies devoted to making a profit who have proved capable of enticing the most profitable—in other words, the healthiest—subscribers away. And the well-capitalized competitors are capable of providing lower-cost coverage through sophisticated managed-care products that require significant technology investments.

- Substantially because it was the insurer of last resort at regulated rates that did not cover the cost of service, over the past 10 years Empire has lost $800 million and a substantial portion of its subscriber base.
- Although Empire is no longer the only insurer of last resort (all HMOs now share this significant role), Empire's resources have been drained to dangerously low levels by its unprofitable but plainly charitable services, for example, its direct pay major medical products (available to individuals on a community rated open enrollment basis),[f] and by the loss to competition of its more profitable subscribers.
- Regulatory changes, like the 1987 elimination of Empire's federal tax exemption, and elimination of favorable hospital rate differentials have wiped out those cost advantages that enabled Empire to compete with for-profit companies.
- Empire cannot replenish its resources through increased premiums because it is competing with companies that do not have charitable purposes, are well capitalized, and are subject to less regulation.
- Empire cannot borrow money in its current state, and raising capital through the equity markets is not an option for a not-for-profit company.
- Therefore, Empire lacks the ability to invest in the technologies and strategies to support its profitable products and to improve its competitive position.

Available Options

Several options might be considered by Empire's board. They include: do nothing, quit now through the statutory mechanism of simple dissolution, pursue a merger/acquisition, or restructure.

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[f] For many years, Empire was the only carrier required to offer its health insurance policies to individuals and small groups on an open enrollment, community-rated basis—permitting any customer regardless of age, health status, etc., to purchase coverage. Empire has experienced significant losses in this business; attempts to ameliorate the losses through rate increases have not been successful.

Do Nothing

Empire could continue to operate for a period just as it does now. But, its assets would dwindle in a downward spiral with no capital to compete, and it would lose customers to those who are well capitalized. This option is inconsistent with both the board's duty of care concerning Empire's assets and its duty of obedience to Empire's not-for-profit mission.

Dissolve

Under New York's Not-For-Profit Corporation Law, the board of a Type B nonprofit company like Empire can petition for a judicially-supervised dissolution of the organization under certain circumstances (e.g., when the corporation is no longer able to carry out its purpose).[4] In such cases, any remaining assets are distributed to another not-for-profit entity with a similar mission. Although the distribution is supervised by the state courts, the board has discretion to determine to which not-for-profit entities to distribute the assets. However, in a simple dissolution, chances are that whatever surplus exists ($300+ million of reported surplus) would be significantly eroded by the process. Moreover, simple dissolution with no mechanism to unlock the going-concern value of Empire's profitable business lines could entail significant waste of valuable assets. Dissolution would also put a great burden on Empire's subscribers, who would have to seek insurance and managed health care elsewhere. In addition to lessening competition for insurance and managed care, which could ultimately result in higher prices and less health-care availability for New Yorkers, it would force more than 6,000 employees out of work. In sum, simple dissolution is even less attractive than the *status quo* option of letting Empire's assets dwindle away.

Merger/Acquisition

Another option is merger/acquisition with an entity that has the resources to address Empire's problems. Empire's board spent significant time considering this option. However, it determined that, in addition to complex technical problems concerning issues such as asset valuation, this option had many of the same drawbacks as statutory dissolution. There are no assurances that Empire's assets would remain devoted to its charitable purpose, that Empire's profitable business lines would continue, that Empire's employees would continue to have jobs, or that the operations would remain in New York State. A further complication is that acquisition by a non-Blue company would almost certainly result in the loss of Empire's right to use the Blue Cross and Blue Shield trademarks. And finally, a deal with a competitor could raise antitrust concerns.

The Empire board has carefully studied the options and is convinced that, in these difficult circumstances, the best method of protecting the assets dedicated to the public (charitable) purpose lies in resolving the operating (business) problem internally. This leads to the fourth option: restructuring. After serious consideration, Empire's board has determined that conversion to for-profit status, if done thoughtfully, provides the best—perhaps the only—means of protecting the value of assets dedicated to Empire's public purpose, while continuing operations in line with the not-for-profit organization's historic mission. The board believes that its duty is to move in this direction.

Restructure

It is a generally accepted truism that organizational form affects the ability of an organization to survive in a market. Different organizational forms will be more or less able to meet the technological, social, and economic demands of a market. Over time, environmental forces in a market will tend to weed out less efficient forms.[5] The not-for-profit form hampers Empire's ability to obtain needed capital.

Clearly, the combination of Empire's business and charitable purposes in a not-for-profit entity no longer works, given the current competitive and regulatory environment. A change in organizational form that enables capital to be obtained could result in a capture of the inherent "equity" value believed to reside in certain of Empire's insurance and managed-care products, such that it could be dedicated toward Empire's historic purpose, while allowing continuity in the provision of insurance and health-care services to the benefit of Empire's subscribers and employees. That is to say, the current proposal reflects an effort by Empire's board to reconcile its duty of care concerning Empire's assets and its duty of obedience concerning Empire's mission. These duties are reconciled by the current plan to transfer Empire's assets and liabilities to a for-profit entity that would operate the health coverage businesses in exchange for the capital stock in the for-profit organization.[g] Thus, the board preserves the assets devoted to the public purpose (as stock in the nonprofit company) while enabling the continued provision of service by the for-profit company, such that the latter can survive and, hopefully, thrive. By putting the "business" into a for-profit entity with access to the capital markets, the business has a chance to compete in today's health-care market and to continue providing services. By devoting the stock of the business to "charitable purposes" in a foundation, the goal of improving the health of New Yorkers continues to be met, and 100% of the historical assets of the nonprofit Empire remain devoted to the public good. If the business survives and thrives, the increase in the value of its stock will support the foundation's purpose.

All the details are yet to be worked out, and regulators, including the Attorney General and Insurance Department, will continue to be involved in developing the plan. Because the technique through which the proposed restructuring will take place

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[g] According to the January 22, 1997, Draft Proposal:

Empire proposes to transfer substantially all its assets, liabilities, and businesses to its recently formed for-profit subsidiaries (referred to collectively as the "for profit company"). . .in exchange for the capital stock of the for-profit company. The transaction would be subject to approval by the New York State Supreme Court in accordance with section 510 of the New York State Not-for-Profit Corporation Law. The non-profit company would then convert to a tax exempt charitable foundation.

One hundred percent of the stock of the for-profit company will be transferred to the foundation. The transfer would be followed by a sale of a portion of the stock in an initial public offering. . . The capital markets will establish the value of the stock of the for-profit company at the time of the initial public offering.

According to the Draft Proposal, after the transfer of the assets, Empire will become a not-for-profit charitable foundation that can qualify for federal tax exempt status under section 501(c)(3) of the Internal Revenue Code. The for-profit company will have no control over the foundation, and the foundation's voting control over the for-profit company will be limited to comply with Blue Cross and Blue Shield Association Rules. The foundation will be required to reduce its ownership interest in the for-profit company to 5% over a 5- to 7-year period to comply with Association Rules. In addition, the regulations governing section 501(c)(3) tax exempt organizations will require a reduction in such ownership to less than 20% within that time frame. The foundation will not be permitted to increase its ownership interest in the for-profit company.

involves the sale of assets of a not-for-profit entity, it must accord with strict statutory requirements, and it is subject to court approval. Thus, the State has ample opportunity to provide oversight of the public policy issues concerning the restructuring and, importantly, the ultimate use of the not-for-profit foundation's assets.

It is quite doubtful that the foundation will broadly provide health insurance benefits to a set of subscribers as Empire historically has done. The current plan proposes that the foundation would be dedicated to promoting the availability and accessibility of high-quality health care and related services to the people of the State of New York. This is consistent with Empire's traditional mission, and it would preserve Empire's traditions; it would therefore be appropriate under the doctrine of *cy pres*. This "ancient doctrine of approximation" is designed to protect assets given in trust for a particular charitable purpose by ensuring that the assets continue to be used for the general purpose for which they were intended. Specific uses of funds would be determined by the foundation's board—a board that, under the current plan, would be wholly independent of the for-profit board.

Empire's traditional mission of ensuring access to health care can be met in many ways, and it should go without saying that there remain significant needs in the insurance and health-care areas that for-profit entities have little interest in filling. For example, the foundation could subsidize insurance for persons who are unable to afford it, yet who are ineligible for Medicaid. Filling this gap would be a great service to all New Yorkers. In a similar vein, the foundation might use its funds to assist over stretched hospitals serving low-income communities. Or it might devote resources to providing health-care services for children who would not otherwise be served.

Clearly, the charitable use to which Empire's assets are put is an important public policy issue. It is appropriate that the State should have input in the determination of how the assets are to be used by the new not-for-profit foundation in which they are placed.

Finally, I must emphasize that, unlike some other highly-criticized conversions involving other Blues organizations, this proposal is specifically designed to preserve Empire's assets and to devote them to a public benefit consistent with Empire's historic nonprofit mission. To this end, assets would be sold for their full intrinsic value: nothing would be held back. (This was a big issue in the first Wellpoint restructuring.) The market will ultimately determine the value of the assets. Also, the conversion would not be used to provide a windfall for managers or directors in the form of executive pay or bonus compensation packages. (This is one of the problems in the attempted purchase of Ohio Blue Cross by Columbia/HCA.)

Conclusion

The duties of a not-for-profit board are manifold. In Empire's case, it is the board's efforts to satisfy those duties that lead to the current proposal—a proposal that, I believe, represents the best hope for preserving Empire's assets and continuing the dedication of those assets to its historic mission. Neither the board's duty of care nor its duty of obedience to Empire's not-for-profit mission is fulfilled unless the board takes action, but its options are severely limited. The solution the board has chosen—to separate Empire's business purpose from its charitable purpose in a manner that dedicates the value of Empire's assets to the charitable purpose—serves to reconcile and fulfill the board's duties of care and obedience. It is my hope that the medical community will support the board in this endeavor.

References

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